On August 24, 2016, the Treasury Department issued a white paper critical of four recent investigations by the European Union (EU). This white paper followed previous concerns raised by the Treasury Department and by Congress, especially the Senate Finance Committee. The EU investigations claimed that certain countries had provided illegal state aid via favorable tax rulings. The most significant in monetary terms is Ireland's rulings for Apple. There are also investigations of Starbucks in the Netherlands and Amazon in Luxembourg. (The remaining non-U.S. firm is Fiat Chrysler, also in Luxembourg.) A decision has been reached for Starbucks to pay €20-€30 million ($22 to $33 million at exchange rates as of August 31, 2016) and is on appeal by the Netherlands to the courts; the Amazon decision is pending. On August 30, 2016, the EU announced a decision requiring Apple to pay Ireland €13 billion in back taxes, or $14.5 billion, plus interest. This action will be appealed by Ireland. The EU has also opened an investigation into a Luxembourg ruling for McDonalds. The discussion in this Insight focuses on the Apple case.

The EU claims of state aid are based on advance pricing agreements (or transfer pricing agreements) with the firms' respective countries, which determine how profits are divided between related parts of the firm. Generally agreed-to principles are that such transactions should be at arms-length (the prices charged unrelated parties), although as a practical matter this pricing is difficult to perform in the case of intangible assets where there are no comparable unrelated transactions.

A typical tax planning arrangement for a U.S. firm with intangible assets (such as technology, know how, or brand name) to operate in Europe is to set up a foreign subsidiary (or subsidiaries) that largely exists to hold these intangible assets. This subsidiary is typically set up in a way that it is eligible for deferral from U.S. tax on its earnings and subject to little or no foreign tax. It may be without a tax home, as in Apple's case, because under former Irish law a tax home depended solely on the place of management (determined by place of board meetings), or with a tax home in a zero-tax location such as Bermuda or the Cayman Islands. That subsidiary in turn has a branch or another subsidiary that is subject to tax and performs the actual operations (for example, purchasing and selling phones).

Profit shifting from the U.S. point of view focuses on the price paid by the holding company to its U.S. parent for the rights to the intangibles, which affects how much profit is currently subject to tax in the United States. Companies may pay upfront payments or buy-in payments for existing intangibles to a parent, royalties for existing intangibles, or, as
appears the case with Apple, cost-sharing payments for conducting research in the United States with the sharing of profits. A cost-sharing payment is not a royalty but a reimbursement of research costs in return for a right to future profits, that generally follows an initial buy-in payment for preexisting intangibles.

Apple had two subsidiaries with taxable operating branches. Profit in each case was allocated between the head office and an operating branch. The Apple transfer pricing agreement assigned most of the profits to the non-taxable head offices to compensate the head office for the use of the intellectual property.

Without a final document, this discussion relies on the EU press release announcing the decision. That decision assigned all of the profits in Ireland to the taxable (at 12.5%) branch operation (with the exception of some interest income), which is the reason for the large tax amount of $14.5 billion.

Based on that press release, the position that the EU took might be described in the following way. The pricing agreement "did not correspond to economic reality: almost all sales profits recorded by the two companies were internally attributed to a 'head office.' The Commission's assessment showed that these 'head offices' existed only on paper and could not have generated such profits. These profits allocated to the 'head offices' were not subject to tax in any country under specific provisions of the Irish tax law, which are no longer in force." The document goes on to point out that the head offices had no employees, no physical presence, and only occasional board meetings.

In contrast, the EU decision may be described in the following way. The decision made by the EU appears inconsistent with the principles underlying arms-length pricing. The EU was apparently not objecting to the Irish tax law that allows a company to be managed elsewhere and not subject to tax. Rather its objective, at least in prior documents made public and in other decisions, was to determine if the royalty paid by the taxable operating branches to the holders of the intangible asset (the transfer price) was reasonable. Such a royalty would be expected to be large and certainly not zero. The lack of local employees of the head office does not negate its ownership of intellectual property.

A related issue addressed by the Treasury white paper is whether the decisions of the EU are consistent with EU rules requiring "illegal" state aid to be selective. The Treasury suggests that if the treatment is available to other multinationals it is not selective; the EU appears to be adopting a broader definition that it is selective if it is not available to standalone companies. With regard to the first view, similar tax benefits have been provided by Ireland through somewhat different techniques, such as the double-Irish, Dutch sandwich, which has benefitted Google and other companies.

Other Treasury concerns expressed were the retroactivity of the EU actions (for the past 10 tax years); the general undermining of the international tax system, including bilateral treaties; and the loss of U.S. future tax revenue on repatriations through tax credits for foreign taxes paid.